Overview of Pension Protection Act of 2006

1. Prescribed funding methods and prescribed actuarial assumptions:

PPA has prescribed the major actuarial assumptions as follows:

Interest Rate: The interest rate used for discounting liabilities is based on a yield curve of investment grade corporate bonds that will be averaged over the most recent 24 months. This is used to generate segment interest rates over the following time frames:
- **Short Term Segment Rates**: used to discount liabilities payable in the time frame of 0-5 years from valuation date.
- **Medium Term Segment Rates**: used to discount liabilities payable in the time frame of 5-15 years from valuation date.
- **Long Term Segment Rates**: used to discount liabilities payable in the time frame of more than 15 years from valuation date.

Mortality: Specific mortality tables prescribed by the Secretary of Treasury are mandatory; large plans can apply for an exception to use their own mortality table. These prescribed mortality tables are updated with the latest longevity improvements.

Funding Method: Unit Credit funding method

**Contribution Range**
The prescribed funding method and assumptions are used to value employee benefit liabilities and calculate a contribution range. The minimum amount of contribution required to be made is referred to as the Minimum Required Contribution (MRC). The maximum allowable contribution is referred to as the Maximum Deductible Contribution. The plan sponsor can make an annual contribution to the fund of an amount that is anywhere within the above specified range. If the sponsor makes a contribution that is less than the Minimum Required, then the plan has a funding deficiency and must pay an excise tax on the deficient amount; and if the sponsor makes a contribution that is greater than the Maximum Deductible the sponsor will have to pay an excise tax on the excess contribution. The actuary assists the sponsor in deciding the appropriate amount of contribution to put into the plan subject to current funding levels, financial flexibility of sponsor, and future plans of the plan sponsor.

**Credit Balances**
A credit balance is created when a sponsor in a particular year makes a contribution that is more than the Minimum Required Contribution for the year. The excess contribution amount counts as a credit balance. Credit balances developed prior to 01/01/2008 are called Carryover Balances; credit balances developed after 1/1/2008 are called Pre-funding Balances. A plan can elect to adjust its existing credit balance against its Minimum Required Contribution (subject to certain conditions of funded status).
**Funded Status**
The plan’s funded status is calculated based on following funding ratios:

- **Funding Target Attainment Percentage (FTAP)**
  
  \[
  \text{Funding Target Attainment Percentage} = \frac{(\text{Assets} - \text{Carryover Balance} - \text{Pre-funding Balance})}{(\text{Funding Target})}
  \]

- **Adjusted Funding Target Attainment Percentage (AFTAP)**
  
  \[
  \text{Adjusted Funding Target Attainment Percentage} = \frac{(\text{Assets} - \text{Carryover Balance} - \text{Pre-funding Balance} + \text{Value of Annuities purchased for Non-Highly Compensated employees in prior two years})}{(\text{Funding Target} + \text{Value of Annuities purchased for Non-Highly Compensated employees in prior two years})}
  \]

**Funded Status certification and Plan Restrictions**
The AFTAP of the plan has to be certified by the plan Actuary within the prescribed deadlines. If not certified in a timely manner, the plan is deemed to be certified at an AFTAP of less than 60% with consequential plan restrictions till the time the plan Actuary duly certifies the AFTAP.

**Plan Restrictions**
Based on the AFTAP ratio, the plan may be subject to certain benefit payment restrictions or plan amendment restrictions. The following are the AFTAP thresholds at which restrictions are triggered:

- **AFTAP ≥ 80%** → No restrictions on the benefit plan
- **80% > AFTAP ≥ 60%** → No plan amendments increasing plan benefits are permitted unless additional contributions are made to bring the AFTAP up to 80% under the amended formula. Limitation on prohibited benefit payments.
- **AFTAP < 60%** → Cessation of benefit accruals. No prohibited benefit payments permitted to be paid. No shutdown benefits or unpredictable contingent events benefits permitted to be paid.

**Notice to Participants**
Notices are required to be sent to all plan participants informing them of any restrictions imposed on the plan based on the plan’s AFTAP certification. This creates transparency in the plan reporting and keeps participants informed at all times of the “health” of their retirement benefits.

**At-Risk Plans**
Severely under-funded plans will be labeled as At Risk plans. An “At Risk” plan will need to fund its liabilities using more aggressive funding schedules and assumptions. Plans with fewer than 500 participants in the preceding plan year are exempt from the at-risk funding requirements.

**Annual Filing**
After the plan sponsor puts in the annual contribution, the actuary files a Form 5500 Schedule SB with the Internal Revenue Services. This Schedule SB filing details the plan assets, plan liabilities, annual contribution made for the plan year and development of credit balances. This form has to be certified and signed by the plan Actuary.
Insurance Coverage
All plans (with certain exceptions for groups of professionals or state/church plans) are required to be insured by the Pension Benefit Guarantee Corporation (PBGC). The plans pay annual premiums to the PBGC and hence avail of insurance coverage from the PBGC in the event that the plan files for bankruptcy or distress termination. The annual premium amount payable is calculated per year based on the number of participants in the plan that have accrued benefits and the amount of unfunded benefits. PBGC was created by the Employee Retirement Income Security Act of 1974 to encourage the maintenance of private-sector defined benefit pension plans, provide security to participant’s pension benefits and yet keep pension insurance premiums at a minimum. PBGC collects insurance premiums from employers that sponsor insured pension plans, earns money from investments and receives funds from pension plans it takes over.

Terms
1. **Funding Target** is defined as the present value of accrued liabilities discounted using the prescribed segment interest rates and prescribed mortality decrements.
2. **Minimum Required Contribution** is the sum of Target Normal Costs for all participants: Present Value of all benefits that plan participants will accrue during the plan year. If there is a funding surplus, the target normal cost gets offset by this amount. **Shortfall Amortization Charge:** This is the amortization of the excess of the Funding Target over the Assets; amortization period is seven years.
3. **Maximum Deductible Contribution** is the sum of: Funding Target + Target Normal Cost + Cushion Amount.
4. **Cushion Amount:** Cushion Amount is the sum of 50% of Funding Target for the plan year and increase in funding target attributable to future compensation increases.
5. The market value of assets or smoothed value of assets can be used in the calculations. The asset values are permitted to be smoothed over three years and smoothed actuarial asset values are restricted to between 90% to 110% of market value of assets.
6. **Non-Highly Compensated Employees:** An employee is classified as a non-highly compensated employee if he is not a Highly Compensated Employee (HCE). A HCE is an employee who is either a 5% owner or is in the top-paid group as determined by compensation.

Is this an improvement?
The funding reforms of the Pension Protection Act 2006 have served well to simplify the funding rules and accelerate funding obligations of defined benefit plans. Key improvements:
1. Prior to PPA, the interest rates used to discount future liabilities were averaged over 4 years and the asset values used to calculate the Minimum Required contributions could be “smoothed” over 5 years within a corridor of 80% - 120% of the market value of assets; hence neither assets nor liabilities were appropriately calculated.
2. Prior to PPA, the shortfall of the liabilities over the assets could be amortized over a period as long as thirty years as compared to only seven years under PPA.
3. Prior to PPA, plan sponsors and actuaries were permitted to use any standard funding method; hence this flexibility could be creatively misused to minimize the annual minimum required contribution; this led to plans not being adequately funded.
4. Too much flexibility in choice of assumptions pre-PPA made it difficult to compare funded status of various plans.
5. Prior to PPA, sponsors were able to misuse their credit balances as they could go for several years without making any contributions simply because they had made excess contributions in past years.

Unquestionably, 2008 has been a tough year for US pension plans since this is the first year the PPA 2006 funding regulations have come into effect so several plans have seen a large dip in estimated funded status simply due to the change in prescribed funding methods and assumptions. Added to this has been the economic downturn and crash of asset values of several large plans that has invested in equities and real estate. Actuaries have been faced with the tough job of confirming to all of the new funding regulations and giving timely advice to the clients to prevent them from getting into benefit restrictions. The next five years or so will be the acid test to judge whether PPA has achieved its aim of stabilizing and strengthening the funded status of US defined benefit pension plans or not.